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2004 annual report

transfers continue to rise

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letter from the director

For the first time since 1995, the Montana Lottery's transfer to the State of Montana exceeded $8 million. While we feel very good about this achievement, we also realize that more than $400,000 of that transfer is because of unusual circumstances—a large refund from the Multi-State Lottery Association's Powerball game reserve fund.

The game reserve fund was set up for the unlikely case of an unanticipated financial need. Each lottery jurisdiction contributes to the game reserve fund in relation to sales. With new lotteries joining the Powerball game, the Montana Lottery's required contribution decreased, and our excess was returned.

Without the $400,000 from the Powerball game, the Lottery's transfer to the General Fund would have been approximately $7.6 million, a 3.1 percent increase over fiscal year 2003. Even this amount exceeded the Montana Lottery target for fiscal year 2004, because of higher than anticipated jackpots. We believe our goal of $7.2 million in fiscal year 2005 is a realistic goal, barring unusual circumstances.

While we appreciate the fact that sales also increased in fiscal year 2004, about 5.9 percent over fiscal year 2003, our achievement of aggressively managing operating expenses is where we feel the most pride in our operation. Our entire staff makes every effort to responsibly spend money, with generating sales and efficiently running a secure Lottery in mind. Every expenditure is evaluated for its necessity. Contracts and bids are negotiated with the idea that meeting the bottom line is as important as increasing sales. As a result, in fiscal year 2004, our operating expenses for the fifth year in a row were approximately $4 million.

These circumstances have lead to another successful year for the Montana Lottery, and I thank our Commission, our staff, and our retailer network for their many contributions.

Sincerely,

Gerald J. LaChere

Gerald J. LaChere
Director

letter from the commissioners

The Lottery Commission consists of five members of the public appointed by the Governor to oversee the operation of the Lottery. One member must be a law enforcement officer; one must be a CPA licensed in Montana; and one must be a member of the Montana State Bar. Commissioners are appointed to four-year staggered terms.

The Montana Lottery is a government-operated business enterprise which generates a profit for the State of Montana. Lottery operations are funded entirely through the sale of Lottery products. No tax dollars are used to support the Lottery.

In fiscal year 2004, the Lottery's operating expenses were nearly identical to operating expenses over the past four years, approximately $4 million. The operating expenses are the one area of our financial picture that can be managed by the Lottery Director and his staff.

As you review our financial statements, you see the operating expenses for fiscal year 2004 are only slightly higher than last year, in spite of a significant increase in revenue. This is evidence of the strength of management the Montana Lottery has enjoyed under the leadership of Director LaChere. It has also laid groundwork for the future successes of the Montana Lottery.

With seventeen years of operation in Montana, we acknowledge the good the Lottery has provided through its assistance in funding important state programs. We look forward to our continued success for the benefit of the people of Montana.

L to R Standing: Commissioners Cliff Brophy, Columbus; Don Sterhan, Billings; Tom Keegan, Helena.
L to R Seated: Commissioner Betty Wilkins, Missoula; Chairman Bob Crippen, Butte.

In fiscal year 2004, sales in Scratch tickets totaled $10,378,001.

- Sold at approximately 600 locations around the State of Montana.
- The Montana Lottery introduced 35 different Scratch games in fiscal year 2004.
- Tickets sell for $1, $2, $3, and $5, and each game features unique play styles, graphics, and prize levels.
- Prizes paid in fiscal year 2004 totaled $6.2 million.
- By law, at least 45 percent of all sales are returned to players as prizes. In fiscal year 2004, the overall percentage was 59.7%.
- Overall odds of winning a prize on Scratch tickets are approximately 1 in 4.
- Over 115 tickets worth over $250 were paid.
- Over 300 tickets worth $100 to $249 were paid.
- Over 152,000 tickets worth $10 to $99 were paid.
- Over 1.3 million tickets worth $1 to $9 were paid.
- Total number of winners in fiscal year 2004 was approximately 1.5 million.
- Each Lottery retailer receives a 5% commission on net sales, with the potential for earning additional commissions on sales over base. Retailer commissions in fiscal year 2004 totaled over $769,000, or 7.4%.

In fiscal year 2004, Montana Cash sales totaled $4,186,863.

- Sold at approximately 550 locations around the State of Montana.
- Montana Cash prizes paid in fiscal year 2004 totaled $2.2 million.
- In fiscal year 2004, overall prize percentage for Montana Cash was 52.8%.
- Overall odds of winning a prize on Montana Cash are approximately 1 in 43.
- Fifteen jackpot tickets worth from $30,000 to $170,00 were sold.
- Over 2,900 tickets worth $200 were paid.
- Over 85,000 tickets worth $5 were paid.
- Total number of winners in fiscal year 2004 was approximately 88,000.
- Each Lottery retailer receives a 5% commission on gross sales. Retailer commissions in fiscal year 2004 totaled over $209,000.

In fiscal year 2004, Wild Card sales totaled $2,329,385.

- Sold at approximately 550 locations around the State of Montana.
- Wild Card prizes paid in fiscal year 2004 totaled $1.2 million.
- In fiscal year 2004, overall prize percentage for Wild Card was 52.8%.
- Overall odds of winning a prize on Wild Card are approximately 1 in 6.
- One jackpot ticket worth $130,000 was sold in Montana in fiscal year 2004.
- Over 260 tickets worth over $250 were paid.
- Over 3,200 tickets worth $10 to $99 were paid.
- Over 334,000 tickets worth $1 to $9 were paid.
- Total number of winners in fiscal year 2004 was approximately 338,000.
- Each Lottery retailer receives a 5% commission on gross sales. Retailer commissions in fiscal year 2004 totaled over $116,000.

In fiscal year 2004, Powerball sales totaled $16,972,086.

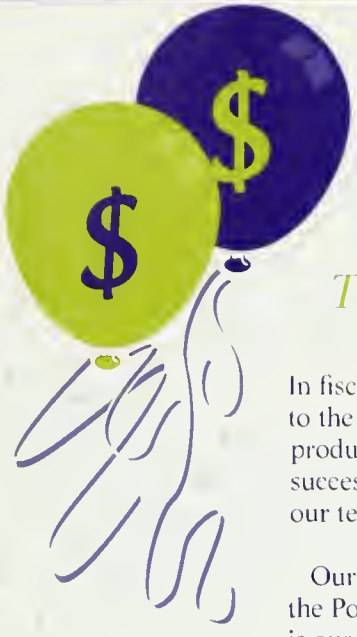
- Sold at approximately 550 locations around the State of Montana.
- Power Play, a feature in which winners have a chance to multiply their non-jackpot prizes up to five times.
- Powerball prizes paid in fiscal year 2004 totaled nearly $7.6 million.
- In fiscal year 2004, overall prize percentage for Powerball was 47.3%.
- Overall odds of winning a prize on are approximately 1 in 36.
- Four tickets worth $100,000 were sold in Montana in fiscal year 2004.
- Over 100 tickets worth over $250 were paid.
- Over 2,100 tickets worth $100 to $249 were paid.
- Over 12,600 tickets worth $10 to $99 were paid.
- Over 350,000 tickets worth $3 to $9 were paid.
- Total number of winners in fiscal year 2004 was approximately 364,900.
- Each Lottery retailer receives a 5% commission on gross sales. Retailer commissions in fiscal year 2004 totaled over $849,000.

In fiscal year 2004, Hot Lotto sales totaled $2,455,021.

- Sold at approximately 550 locations around the State of Montana.
- Hot Lotto prizes paid in fiscal year 2004 totaled $1.2 million.
- In fiscal year 2004, overall prize percentage for Hot Lotto was 48.2%.
- Overall odds of winning a prize on are approximately 1 in 16.
- One jackpot ticket worth $3.68 million was sold in Montana, for the October 8, 2003 drawing.
- Over 40 tickets worth over $250 were paid.
- Over 1,730 tickets worth $10 to $99 were paid.
- Over 132,000 tickets worth $2 to $9 were paid.
- Total number of winners in fiscal year 2004 was approximately 134,600.
- Each Lottery retailer receives a 5% commission on gross sales. Retailer commissions in fiscal year 2004 totaled almost $122,000.

Qwik Tix are instant win games printed by the Lotto terminal. They were introduced on February 2, 2004.

- Sold at approximately 550 locations around the State of Montana.
- Players can play Qwik Tix, sold at $2 per ticket, as two Qwik Tix plays, or in combination with a partner Lotto game.
- In fiscal year 2004, Qwik Tix sales totaled $436,301.
- Qwik Tix game names are Lucky Numbers, Hot-Tac-Toe, Jacks or Better, and Montana Match.
- Qwik Tix prizes paid in fiscal year 2004 totaled $272,000.
- In fiscal year 2004, overall prize percentage for Qwik Tix was 62.4%.
- Depending on the combination played, overall odds of winning a prize are approximately 1 in 4 to 1 in 18.
- Over 100 tickets worth $250 or more were paid.
- Over 60 tickets worth $100 to $249 were paid.
- Over 5,600 tickets worth $10 to $99 were paid.
- Over 30,000 tickets worth $2 to $9 were paid.
- Total number of winners in fiscal year 2004 was approximately 36,000.
- Each Lottery retailer receives a 5% commission on gross sales. Retailer commissions in fiscal year 2004 totaled almost $25,000.



There are many ways to win!

In fiscal year 2005, the Montana Lottery's main strategy will continue to be maximizing our transfer to the State of Montana. We will continue to aggressively manage expenses, while introducing new products appropriate for Montana. Our advertising strategy will ad a few elements to our previously successful image campaign, "For the Fun of It." We will incorporate Public Service Announcements in our television and radio mix.

Our advertising strategy for Powerball will change slightly this fiscal year as well. We will advertise the Powerball game throughout the year, using 15-second television and radio spots. Since Powerball is our lead product, top-of-mind awareness will, we hope, stimulate sales in Powerball, with perhaps some residual affect on our other Lotto games. This effort may also increase our sales at lower jackpot levels.

We do not anticipate significant increases for the year, but we do expect our sales to be in excess of $36 million. More importantly, our transfer should maintain the level we have established in the past three years, at more than $7 million, and more than 20 pereent of revenue.

independent auditors' report

To the Commissioners
Montana State Lottery
Helena, Montana

We have audited the accompanying financial statements of the Montana State Lottery (the Lottery), an enterprise fund of the State of Montana, as of and for the years ended June 30, 2004 and 2003. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the Lottery and are not intended to present the financial position of the State of Montana and the results of its operations and cash flows of its proprietary fund types in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Lottery, an enterprise fund of the State of Montana, as of June 30, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued a report dated October 8, 2004 on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 8 through 10 are not a required part of the basic financial statements but are supplementary information recommended by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Galusha, Higgins & Galusha, PC

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
October 8, 2004

The following *Management Discussion and Analysis* (MD&A) of the Montana State Lottery's (the Lottery) activities and financial performance provides the reader with an introduction to and overview of the financial statements for the fiscal years ended June 30, 2004 and 2003. We encourage readers to consider this information in conjunction with the financial statements, which directly follow.

OVERVIEW OF THE FINANCIAL STATEMENTS

The Lottery is classified as a special-purpose government fund engaged only in business-type activities. Accordingly, the Lottery operates in much the same manner as commercial enterprises using the full accrual method of accounting in accordance with accounting principles generally accepted in the United States of America. The basic financial statements consist of two components:

1) Three Fund Financial Statements: a *Statement of Net Assets*, a *Statement of Revenues, Expenses, and Changes in Fund Net Assets*, and a *Statement of Cash Flows*; and

2) Notes to the Financial Statements.

The *Statements of Net Assets* provides information about the nature and amounts included in both short-term and long-term assets and liabilities at the end of the year. Long-term fixed assets are capitalized and depreciated over their useful lives. Because the Lottery is required to transfer all "profits," or the excess of assets over liabilities, to the State's General Fund, its "net assets" will always be zero.

The *Statements of Revenues, Expenses, and Changes in Fund Net Assets* includes all of the current years' revenues and expenses. Revenues are recognized when earned and become measurable, not when they are received. Expenses are recognized when incurred, not when paid. This statement measures the success of the Lottery's operations over the past two years and details the total amount transferred to the General Fund.

The final presentation is the *Statements of Cash Flows*. The primary purpose is to provide information about the cash receipts and payments during the reporting period. The statement also reports changes in cash resulting from operations, investing and financial activities, and provides answers to questions such as where cash came from and what cash was used for.

NET ASSETS

The table below presents a summary of the Lottery's *Statements of Net Assets*.

Condensed Statements of Net Assets as of June 30, 2004 and 2003

	2004	2003	Dollar Change	Percentage Change
Current Assets	$2,499,205	$2,132,236	$ 366,969	17.2%
Capital Assets (Net of Depreciation)	1,921,498	2,954,696	(1,033,198)	-35.0%
Other Assets	1,325,275	1,742,643	(417,368)	-24.0%
Total Assets	**$5,745,978**	**$6,829,575**	**$(1,083,597)**	**-15.9%**
Current Liabilities	$4,384,114	$5,052,373	$ (668,259)	-13.2%
Long-Term Liabilities	1,361,864	1,777,202	(415,338)	-23.4%
Total Liabilities	**$5,745,978**	**$6,829,575**	**$(1,083,597)**	**-15.9%**
Invested in Capital Assets, Net of Related Debt	$1,921,498	$1,844,860	$ 76,638	4.2%
Unrestrieted Net Assets	(1,921,498)	(1,844,860)	(76,638)	4.2%
TOTAL NET ASSETS	**$ 0**	**$ 0**	**$ 0**	**0**

The largest changes in Current Assets are a $427,000 increase in inventory due to shipments of scratch tickets received in June, and a $100,000 decrease in Accounts Receivable. The $1 million decrease in Capital Assets is due to depreciation on the Games Management System and amortization of the software associated with that system. The decrease in Other Assets represents a partial refund of reserves held by the Multi-State Lottery Association (MUSL) for payment of Powerball prizes. Each member jurisdiction participating in Powerball contributes to the reserve in relation to its sales. Additional members have joined the Powerball group, which decreased Montana's required contribution. Because the original payments were considered prize expense, the $442,068 refund also reduced prize expense in this year.

Current Liabilities decreased by $1.1 million because of the final payment on the Lottery's loan for the purchase of the gaming system equipment (additional information on this debt is contained in the debt analysis section) and $110,000 in deferred revenue due to smaller jackpots at June 30th compared to the previous year. There were increases in Current Liabilities due to higher outstanding prize liability of $188,000 and an increased transfer amount of $352,000 owed to the General Fund. Long-Term Liabilities decreased with the receipt of the Powerball reserve refund explained above. The prize reserves held by MUSL for all games are represented on the financial statements as a long-term asset and an offsetting long-term liability.

The category, Invested in Capital Assets, Net of Related Debt, consists of capital assets less accumulated depreciation, amortization and the outstanding balance on the debt related to the purchase of these assets, if any.

OPERATIONS AND CHANGES IN NET ASSETS

The table below presents a summary of the Lottery's Operations for the last two years.

Condensed Statements of Revenues, Expenses & Changes in Fund Net Assets
For the Years Ended June 30, 2004 and 2003

	2004	2003	Dollar Change	Percentage Change
Operating Revenues	$36,740,200	$34,696,380	$2,043,820	5.9%
Direct Game Costs	(24,541,603)	(23,257,373)	(1,284,230)	5.5%
Net Operating Revenue	**$12,198,597**	**$11,439,007**	**$ 759,590**	**6.6%**
Operating Expenses	(4,095,972)	(3,981,365)	(114,607)	2.9%
Net Operating Income	**$ 8,102,625**	**$ 7,457,642**	**$ 644,983**	**8.6%**
Non-Operating Income/(Expenses)	12,977	(4,361)	17,338	397.6%
Income Before Operating Transfer	**$ 8,115,602**	**$ 7,453,281**	**$ 662,321**	**8.9%**
Transfer to General Fund	$(8,115,602)	$(7,453,281)	$ (662,321)	8.9%
Change in Net Assets	**$ 0**	**$ 0**	**$ 0**	**0**

Strong sales of Powerball, Montana Cash and Hot Lotto resulted in an overall increase of 5.9% for operating revenue over fiscal year 2003. Direct Game Costs, which include prizes, system vendor fees, retailer commissions and scratch ticket printing, are directly related to sales. Prizes expense was reduced by the Powerball reserve refund mentioned above and therefore Direct Game Costs increased by only 5.5% over last year.

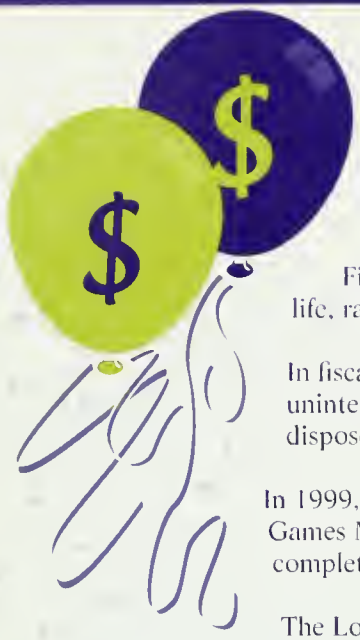
Total Operating Expenses increased slightly. The individual expense categories of Advertising and Contractual Services increased by $78,696 and $44,852, respectively, due to expenses associated with the introduction of Qwik Tix.

The income from Non-Operating activities increased from the previous year. This category includes interest received from investments and interest paid on the long-term loan. The long-term loan was paid in full in April and overall interest expense payments were $55,560 less than in 2003.

The increase in sales, prize expense abatement and steady operating expenses resulted in the Lottery transferring more that $8 million to the General Fund. This is an increase of 8.9% over fiscal year 2003.

CAPITAL ASSETS AND DEBT ADMINISTRATION

The Lottery follows the State's policy of capitalizing fixed assets with an historical value of $5,000 or more. The Lottery fixed assets are divided into three categories: 1) a fleet of vehicles used by the sales staff, 2) office or computer equipment, and 3) the Games Management System (GMS), which tracks and controls the sale of all Lottery products, validation of



winning tickets, and payments to winners. GMS consists of centralized computer equipment and operating software located in Helena and includes all of the terminals (selling scratch tickets, Qwik Tix and lotto games) located at retail locations. GMS prints over 70% of the lottery tickets, the remainder are scratch tickets, which are produced by a secure printing company.

Fixed assets are depreciated using the straight-line method over the appropriate estimated useful life, ranging from three to seven years.

In fiscal year 2004, fixed asset purchases consisted of a replacement vehicle for $19,333, an uninterruptible power supply for the computer systems for $13,366, and a commercial grade shredder to dispose of outdated scratch tickets for $6,140.

In 1999, the Lottery entered into a loan agreement with Norwest Investment Services to purchase the Games Management System. The 5-year loan was for $5,025,311 at 5.12% interest. This loan was completely satisfied in April 2004.

The Lottery has no other debt-related commitments.

LOOKING AHEAD

The Lottery's goal is to maximize revenue for the State's programs while maintaining the public trust in lottery gaming. This requires offering games that Lottery players want to play, providing convenient locations for the purchase, and controlling operating expenses.

The Lottery introduces new scratch games on a regular basis. In fiscal year 2004, 35 games featuring different graphics, play styles, and prize levels were introduced. Approximately the same number of newly introduced games will be presented in fiscal year 2005.

Qwik Tix has not been as successful as market research indicated. Therefore, the product line will be re-evaluated to determine if the product will continue, will need to be changed, or will be discontinued in the future.

The Lottery will continue to look for opportunities to meet the expectations of our players for new and interesting games. We will also continue our efforts to increase the number of retail outlets throughout the state with new terminal placements or by upgrading current scratch-only retailers to full service locations to better serve our players.

Exceptional increases in lotto revenue are usually the result of higher jackpots; however, such jackpots cannot be predicted nor depended upon to occur at any specific time. Therefore, omitting the possibility of a record jackpot, the Lottery projects that the transfer to the General Fund in fiscal year 2005 will be approximately $7.2 million.

CONTACTING THE LOTTERY'S FINANCIAL MANAGEMENT

This financial report is designed to provide a general overview of the Lottery's finances for all of Montana's citizens, taxpayers, players and creditors, and to report on the Lottery's accountability for its funds. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Montana Lottery, 2525 N. Montana Avenue, Helena, MT 59604.

statements of net assets

	June 30, 2004	2003
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	297,559	244,733
Accounts receivable, net of allowance	1,149,380	1,248,688
Due from primary government	1,039	584
Due from component units	707	–
Inventory	1,034,181	607,261
Other current assets	16,339	30,970
Total current assets	2,499,205	2,132,236
FURNITURE AND EQUIPMENT		
Furniture and equipment	5,563,836	5,589,216
Accumulated depreciation	(3,929,838)	(3,086,306)
Total furniture and equipment	1,633,998	2,502,910
INTANGIBLE ASSETS		
Software, net of accumulated amortization	287,500	451,786
OTHER ASSETS		
MUSL prize reserve fund	1,325,275	1,742,643
TOTAL ASSETS	5,745,978	6,829,575
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	474,326	465,039
Accrued interest payable	–	10,260
Estimated prize liability	1,528,838	1,340,477
Transfer obligations to general fund	2,188,861	1,811,272
Due to primary government	9,763	35,013
Due to component units	279	–
Deferred on-line revenue	63,777	173,133
Property held in trust	6,000	–
Current portion of accrued compensated absences	112,270	107,343
Current portion of note payable	–	1,109,836
Total current liabilities	4,384,114	5,052,373
LONG-TERM LIABILITIES		
MUSL prize liability	1,283,395	1,699,207
Long-term portion of accrued compensated absences	78,469	77,995
Total long-term liabilities	1,361,864	1,777,202
TOTAL LIABILITIES	5,745,978	6,829,575
COMMITMENTS AND CONTINGENCIES		
NET ASSETS		
Invested in capital assets, net of related debt	1,921,498	1,844,860
Unrestricted net assets	(1,921,498)	(1,844,860)
TOTAL NET ASSETS	–	–
TOTAL LIABILITIES AND NET ASSETS	5,745,978	6,829,575

The accompanying notes are an integral part of these financial statements.

statements of revenues, expenses, and changes in fund net assets

	For the years ended June 30, 2004	2003
OPERATING REVENUES		
Scratch ticket games	10,378,001	10,134,734
On-line games	26,359,656	24,547,760
Miscellaneous	2,543	13,886
Total operating revenues	36,740,200	34,696,380
DIRECT GAME COSTS		
Scratch ticket prize expense	6,199,677	5,918,176
On-line ticket prize expense	12,480,211	11,644,782
Retailer commission	2,090,986	2,035,751
On-line vendor fees	3,066,764	2,899,115
Cost of tickets sold	703,965	759,549
Total direct game costs	24,541,603	23,257,373
Income before operating expenses	12,198,597	11,439,007
OPERATING EXPENSES		
Advertising	634,098	555,402
Communications	89,904	83,602
Advertising production	127,767	158,736
Audit fees	43,335	58,264
Contractual services	190,357	145,505
Depreciation and amortization	1,064,432	1,055,362
Management fees	54,289	70,888
Multi-state operating fees	91,967	89,435
Other	38,770	36,450
Personal services	1,400,905	1,382,005
Public relations	27,292	25,784
Repairs and maintenance	17,685	27,324
Supplies and materials	192,913	160,915
Utilities and rent	108,720	106,443
Travel	13,538	27,250
Total operating expenses	4,095,972	3,981,365
OPERATING NET INCOME	8,102,625	7,457,642
NON-OPERATING REVENUES (EXPENSES)		
Interest income	43,985	77,140
Interest expense	(25,481)	(81,041)
Loss on disposal of furniture and equipment	(5,527)	(460)
Total non-operating net income	12,977	(4,361)
INCOME BEFORE TRANSFERS	8,115,602	7,453,281
TRANSFERS OUT		
General Fund	8,115,602	7,453,281
Total transfers out	8,115,602	7,453,281
Net assets, beginning of year	–	–
Net assets, end of year	–	–

The accompanying notes are an integral part of these financial statements.

statements of cash flows

For the years ended June 30,

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from sales	36,736,154	34,340,379
Cash paid to suppliers for goods and services	(7,876,026)	(6,790,847)
Cash paid to employees	(1,391,042)	(1,299,099)
Cash paid for prizes	(18,504,635)	(17,233,442)
Net cash provided by operating activities	8,964,451	9,016,991
CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES		
Transfers out:		
General fund	(7,738,012)	(7,233,463)
Net cash used by non-capital financing activities	(7,738,012)	(7,233,463)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of fixed assets	(38,840)	(798,396)
Interest paid	(21,536)	(90,792)
Payments on long-term borrowing	(1,124,042)	(1,054,786)
Proceeds from sale of fixed assets	1,039	1,472
Net cash used by capital and related financing activities	(1,183,379)	(1,942,502)
CASH FLOWS FROM INVESTING ACTIVITIES		
Interest and dividend income	9,766	12,508
Net cash provided by investing activities	9,766	12,508
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	52,826	(146,466)
Cash and cash equivalents, beginning of year	244,733	391,199
Cash and cash equivalents, end of year	297,559	244,733
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating income	8,102,625	7,457,642
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	1,064,432	1,053,362
Changes in net assets and liabilities:		
(Increase) decrease in accounts receivable	99,308	(452,417)
Decrease in due from primary government	584	2,061
(Increase) in due from component units	(707)	–
(Increase) decrease in inventory	(426,920)	205,683
(Increase) decrease in other current assets	14,631	(11,883)
Decrease in long-term receivable	417,368	358,253
Decrease in interest receivable included in long-term receivable	34,221	64,631
Increase in accounts payable	9,287	208,191
Decrease in lottery prizes payable	(227,451)	(3,912)
Increase (decrease) in deferred revenue	(109,356)	94,312
Increase in property held in trust	6,000	–
Increase (decrease) in due to primary government	(25,251)	24,565
Increase in due to component units	279	–
Increase in compensated absences payable	5,401	16,523
Net cash provided by operating activities	8,964,451	9,016,991

The accompanying notes are an integral part of these financial statements.

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization - The Montana State Lottery (hereafter referred to as the Lottery) was created in November 1986 by a referendum vote of the people of Montana. Section 23-7-101, Montana Code Annotated (MCA) establishes the provision of the code under which the Lottery operates. The Lottery is operated by a five-member commission consisting of Montana residents appointed by the Governor. The Commission, by law, has the power to operate a state lottery, determine the type and forms of lottery games, set ticket prices, determine the number and size of prizes, conduct lottery drawings, enter into agreements to offer lottery games with other states, and prepare financial reports. The Lottery is attached to the Department of Administration for administrative purposes.

Disposition of revenue is a minimum of 45 percent for prizes and a maximum of 10 percent for commission to sales agents. The remaining revenue, less expenses, is transferred to the Montana State General Fund.

Reporting Entity - The Lottery is included in the State of Montana's financial statements as an enterprise fund. In accordance with governmental accounting and financial reporting standards, there are no component units to be included within the Lottery's financial statements as a reporting agency.

Basis of Accounting - The Lottery utilizes the accrual basis of accounting and is classified as an enterprise fund of the governmental proprietary fund type. Enterprise funds account for operations similar to private business enterprises where the intent of the Legislature is that costs are to be financed or recovered primarily through user charges, or where the Legislature has decided that periodic determination of revenue earned, expenses incurred or net income is appropriate.

Revenue Recognition - Sales of scratch lottery tickets are made to licensed retailers who market the tickets to the public on a commission basis. Revenue is recognized when tickets are activated by retailers. Tickets activated, but not sold by retailers, may be returned for credit. Sales are reduced for estimated ticket returns.

Sales of on-line lotto tickets are made through licensed retailers who market the tickets on a commission basis using computerized terminals. Lotto ticket revenue is recognized on drawing dates. Tickets sold in advance of future drawing dates are recorded as deferred revenue until the ticket becomes valid for a drawing. Qwik Tix revenue is recognized at the time of sale.

Cash and Cash Equivalents - Cash and cash equivalents consist of interest-bearing deposits with the Montana Board of Investments short-term investments pool, cash deposited with banks and cash on deposit with the Montana State Treasurer that is part of the State's pooled cash and is not separately identifiable as to specific types of securities. These funds are highly liquid and may be drawn on daily.

Allowance for Uncollectible Accounts - The Lottery uses the allowance method to account for uncollectible receivables. The allowance is based on management's estimate of possible bad debts.

Advertising Costs - Advertising costs are expensed as incurred.

Allowance for Returned Tickets - The Lottery's policy is to accept any unplayed scratch ticket from a retailer for credit without regard to when the ticket or pack of tickets was activated. Therefore, an allowance to recognize the possibility of returns is calculated at the end of each fiscal year.

Inventory - Inventory consists of tickets and supplies. Ticket inventory includes scratch lottery tickets that are carried at cost using the specific identification method. Tickets are charged to cost of sales when activated. Unsold tickets are charged to cost of sales upon the end or cancellation of the related game. Supply inventory is carried at cost and expensed as used.

Prizes - Prize expense is recognized based on a predetermined prize structure for each scratch ticket and on-line game. Free tickets are recorded as a reduction in revenue and not as prize expense.

Unclaimed Prizes - Prizes for the on-line games, Powerball, Wild Card, Hot Lotto, and Montana Cash, must be claimed within six months after the appropriate draw date. Prizes for Qwik Tix must be claimed within six months of the sales date. Prizes for scratch games must be claimed within six months of the announced end of each game. The unclaimed prize amounts are taken as a reduction in the Lottery Prizes Payable liability and the Prize Expense and are transferred to the State of Montana General Fund as a portion of the quarterly transfer. The combined amounts of unclaimed prizes for online games were $1,063,705 and $957,718 and for the scratch games were $232,349 and $345,029 for the fiscal years ended June 30, 2004 and 2003, respectively.

Intangible Assets - Intangible assets consist of software and represents the unamortized cost of software purchased in 1999. This software had an original cost of $1,150,000 and is being amortized over seven years.

Furniture and equipment - Furniture and equipment are recorded at cost. Donated furniture and equipment are recorded at their estimated fair market value at the date of donation. Ordinary maintenance and repairs are charged to operations as incurred; major renewals and betterments are capitalized. Upon disposition or retirement of furniture and equipment, the cost and related accumulated depreciation or amortization are removed from the accounts. Gain or loss on disposal is reflected in nonoperating revenues and expenses. Depreciation and amortization are calculated on a straight-line basis over estimated useful lives of three to seven years. The Lottery conforms to the State of Montana capitalization threshold for recording furniture and equipment. This threshold is $5,000.

Compensated Absences - State employees earn vacation leave ranging from fifteen to twenty-four days per year based on years of service. Vacation leave may be accumulated to a total not to exceed twice the maximum number of days earned annually. Sick leave accumulates at a rate of twelve days per year with no maximum accumulation. Upon retirement or termination, an employee is paid for 100 percent of unused vacation leave and 25 percent of unused sick leave.

Use of Estimates - The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

NOTE B - CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

	June 30, 2004	June 30, 2003
Short-term investment pool	$ 1,766	$ –
Cash on deposit with State Treasurer	285,643	234,583
Cash in revolving deposit account	10,000	10,000
Petty cash	150	150
	$ 297,559	$ 244,733

The Lottery participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less. There are no legal risks that the Board of Investments is aware of regarding any STIP investments. The bank balance of the revolving deposit account was $12,666 and $149,744 at June 30, 2004 and 2003, respectively, and was covered by federal depository insurance up to $100,000. The carrying amount reported in the Statement of Net Assets for cash and cash equivalents approximates the fair market value.

NOTE C - ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

	June 30, 2004	June 30, 2003
Accounts receivable	$1,265,171	$1,449,930
Allowance for returned tickets	(115,791)	(201,242)
	$1,149,380	$1,248,688

NOTE D - INVENTORY

Inventory consists of the following:

	June 30, 2004	June 30, 2003
Scratch tickets	$ 974,820	$538,571
Supplies	59,361	68,690
	$1,034,181	$607,261

NOTE E - OTHER CURRENT ASSETS

Other current assets consist of the following:

	June 30,	
	2004	2003
Prepaid expenses	$11,539	$26,170
Employee travel advances	4,800	4,800
	$16,339	$30,970

NOTE F -FURNITURE AND EQUIPMENT

A summary of furniture and equipment for the Montana Lottery is as follows:

	June 30, 2003	Additions	Deletions	June 30, 2004
Furniture and equipment	$ 5,589,216	$ 38,840	$(64,220)	$5,563,836
Accumulated depreciation	(3,086,306)	(900,146)	56,614	(3,929,838)
Total	$ 2,502,910	$(861,306)	$ (7,606)	$1,633,998

NOTE G - MULTI-STATE LOTTERY ASSOCIATION (MUSL)

Joint Venture Association - In November 1989, the Lottery joined the Multi-State Lottery Association (MUSL). MUSL was created in September 1987 to operate a multi-state lottery game for the benefit of party lotteries. The Powerball game, Wild Card game and Hot Lotto game are presently the only games operated jointly by the members in which the Lottery participates. Each lottery participating in MUSL is represented on the Board of Directors.

Prize Reserve Fund Receivable/Payable - As a member of the MUSL, the Lottery is required to contribute to various prize reserve funds maintained by MUSL. The contributions are to be used to fund unanticipated prize claims. All funds remitted and the related interest earnings will be returned to the Lottery upon leaving the association, less any portion of unanticipated prize claims, which was paid from the fund.

The Lottery contributes to the reserve fund through the set-aside for prizes. Payments made to the reserve fund are considered a portion of the prize expense associated with the on-line game.

During 1990, the MUSL Board created the unreserved accounts to record interest earned on the various prize reserve funds when the prize reserve fund balance is not below the predetermined ceiling amount. The amounts in the unreserved accounts may be used at the Board's discretion.

The long-term receivable balance of $1,325,275 and $1,742,643 at June 30, 2004 and 2003, respectively, represents the Lottery's share of the MUSL prize reserve fund that had a balance of $104,778,316 and $101,573,922 for 2004 and 2003, respectively. The long-term liability balance of $1,285,395 and $1,699,207 at June 30, 2004 and 2003, respectively, represents the Lottery's share of the total estimated prize liability.

Lotto*America Prizes and Investments - Prizes awarded to Lotto*America grand prize winners are paid in twenty annual installments funded by investments in United States Treasury zero coupon bonds. Bonds purchased on behalf of Montana source winners are held in trust by MUSL with the Montana State Lottery as beneficiary. As the bonds mature, the proceeds are forwarded to the Lottery and distributed to the grand prize winners on the anniversary date of each win.

At June 30, 2004 and 2003, MUSL held United States Government zero coupon bonds in trust for the Lottery winners with respective par values of $44,749,941 and $49,957,949 and respective market values of $37,331,863 and $42,958,311.

The Lottery has eight Lotto*America/Powerball/Tri-West winners receiving annual payments. The combined total future prize payments owed is $44,884,000 and $50,092,000, at June 30, 2004 and 2003, respectively. Total annual payments due over each of the next five years is $5,208,000 annually and $18,844,000 thereafter. The present value of future prize payments approximates the current market value of the bonds held in trust for the Lottery winners.

Multi-State Lottery Association Financial Position - Information related to the Multi-State Lottery Association's audited financial statements is as follows:

	June 30, 2004	2003
Total assets	$1,202,963,173	$1,372,413,265
Total liabilities	1,202,740,173	1,372,128,131
Total net assets	223,000	285,134
Total liabilities and net assets, unrestricted	$1,202,963,173	$1,372,413,265
Total revenues	$ 5,910,374	$ 5,397,356
Total expenses	5,972,508	5,417,637
Decrease in unrestricted net assets	$ (62,134)	$ (20,281)

NOTE H - ESTIMATED PRIZE LIABILITY

The estimated prize liability represents the Lottery's estimate of prizes payable related to games in process at year-end based on the predetermined prize structure of each outstanding game.

NOTE I - OBLIGATION TO TRANSFER FUNDS

The Lottery is required to transfer its net revenue to the Montana State General Fund. This change was enacted through the passage of SB 83 by the 1995 Legislature and signed into law by Governor Racicot in April 1995. Transfer obligations outstanding at June 30, 2004 and 2003 were $2,188,861 and $1,811,272, respectively.

NOTE J - LONG-TERM LIABILITIES

Long-term liabilities consist of the following:

	June 30,			
	Current	Long-Term	2004 Total	2003 Total
Prize liability Multi-State Lottery Association	$ –	$ 1,283,395	$ 1,283,395	$ 1,699,207
Accrued compensated absences	112,270	78,469	190,739	185,338
Note payable - Norwest Investment, interest rate 5.12% for 5 years requiring quarterly payments of $286,394.30. Note was paid in full in 2004.	–	–	–	1,109,836
	$ 112,270	$ 1,361,864	$ 1,474,134	$ 2,994,381

NOTE K - LEASES

The Lottery leases its office, administrative and warehouse facilities under a non-cancelable lease agreement that is effective March 2002 through February 2007. Rent expense under operating leases charged to operations was $87,320 and $86,228 for the years ended June 30, 2004 and 2003, respectively.

The Lottery also has an operating lease for office equipment, primarily the photocopier, with monthly payments of $428, which expires August 2005. Rental expenses for these leases consisted of $5,142 and $5,170 for the years ended June 30, 2004 and 2003, respectively.

Future minimum lease payments under operating leases that have remaining terms in excess of one year as of June 30, 2004 are:

Years ending June 30:

2005	95,234
2006	91,849
2007	61,964
2008	-0-
2009	-0-

NOTE L - EMPLOYEE BENEFIT PLANS

Pension Plan - The Lottery participates in the Public Employees Retirement System (PERS). PERS is a statewide mandatory cost-sharing multiple employer retirement plan which covers all employees. The plan is established under State law and is administered by the State of Montana. The plan provides disability and death benefits to plan members and beneficiaries as well as a choice of a defined benefit or a defined contribution retirement plan.

The plan issues a publicly available financial report that includes financial statements and required supplementary information. The report may be obtained from the following address: Public Employees Retirement System, Montana Public Employees Retirement Administration, P.O. Box 200131, 100 N. Park, Suite 220, Helena, MT 59620-0131, (406) 444-3154.

The contribution rate for the plan is required and determined by State law. The contribution rate for fiscal years 2004 and 2003, expressed as a percentage of covered payroll, was 6.9% for both years, for both the employer and the employees. The amounts contributed to the plan during the years ended June 30, 2004 and 2003, were $147,506 and $147,159, respectively, and were equal to the required contributions for each year.

Deferred Compensation Plan - The Lottery's full-time regular employees are eligible to participate in the State of Montana's deferred compensation plan. The plan is administered by Benefits Corporation on behalf of Great West Life Insurance Company through a contract with the State of Montana. The amount of compensation deferred is not available to employees until termination, retirement, death, or unforeseen emergency. All amounts are deferred under the plan created under Internal Revenue Code Section 457 and Title 19, chapter 50, Montana Code Annotated (MCA). Assets of the deferred compensation plan are required to be held in trusts, custodial accounts or insurance company contracts for the exclusive benefit of participants and their beneficiaries.

NOTE M - RELATED PARTY TRANSACTIONS

During the ordinary course of business, other State agencies provide certain services and supplies to the Lottery. During 2004 and 2003, total payments to other State agencies were approximately $212,750 and $225,332, respectively.

NOTE N - COMMITMENTS AND CONTINGENCIES

Scratch Tickets - The Lottery has an agreement with Oberthur Gaming Technologies Corp. to print scratch game tickets. The contract expires August 8, 2008. The Lottery incurs approximately $750,000 per year under this contract.

On-line Vendor - The Lottery is contracted with Scientific Games International to provide for the operation of an on-line gaming system through March 30, 2006. The estimated total contract price is approximately $24 million over the seven-year contract.

Advertising - The Lottery signed a contract with Banik & Associates to provide advertising services for $5,500 per month through December 2006.

Independent Observation of Drawings - The Lottery is committed to Galusha, Higgins and Galusha, PC, to observe Montana Cash and other special drawings. The term of the contract is for three years ending June 30, 2005. Compensation will not exceed $25,000 for the three-year period.

Audit of Financial Statements - The Lottery is party to a contract with Galusha, Higgins and Galusha, PC, an independent accounting firm, to audit the Lottery's annual financial statements. The yearly contract was finalized on December 12, 2002, and is renewable annually for two additional years with the consent of all parties. Compensation for the years ended June 30, 2004 and 2003 will not exceed $12,000.

Prize Contingencies - Certain Big Spin prizes awarded are payable to the winners in annual installments spanning seventeen to twenty years with the first payment being made by the Lottery. The Lottery has entered into agreements with an insurance carrier under which purchased annuities will provide the required level of payments corresponding to the Lottery's obligation to these prize winners. Because it is the intent of the Lottery that the insurance carrier will make future installment payments directly to each prize winner, neither the present value of the annuities nor the present value of the future payments are reflected in the accompanying financial statements. The Lottery would be liable for such future payments in the gross amount of $697,500 and $950,588 at June 30, 2004 and 2003, respectively, if the insurance carrier defaulted on their payments.

NOTE O - RISK MANAGEMENT/PUBLIC ENTITY RISK POOL

The Lottery contributes to the Group Employee Comprehensive Medical and Dental Plan and the Property and Casualty Insurance plans of the State of Montana. Details of these plans can be found in the State of Montana Comprehensive Annual Financial Report, which can be obtained by contacting Administrative Financial Services Division, Room 255 Mitchell Building, Helena, MT 59620.

independent auditors' report

on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with government auditing standards

To the Commissioners
Montana State Lottery
Helena, Montana

We have audited the financial statements of Montana State Lottery (Lottery), an enterprise fund of the State of Montana, as of and for the year ended June 30, 2004, and have issued our report thereon dated October 8, 2004. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended for the information of the Lottery's Commissioners, management and the Legislative Audit Committee and is not intended to be and should not be used by anyone other than those specified parties.

Galusha, Higgins & Galusha, PC

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
October 8, 2004

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